Economics and Sociology
Occasional Paper #815

ECONOMY-WIDE INFLUENCES ON RURAL FINANCIAL MARKET PERFORMANCE

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Paper Prepared for
The Caribbean Agricultural Credit Training Committee (CACTCOM)
Senior Management Workshop
Georgetown, Guyana

November 17-20, 1980

FEB 1 1984

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The viability of rural credit institutions and programs is an important item on the policy agenda of Caribbean governments, regional agencies, and the credit institutions themselves. Among many decision-makers there is genuine concern about the performance of rural credit programs. Financial advisers have been provided for some struggling institutions in the East Caribbean Common Market. Programs have been redesigned in others. In Jamaica there is even an active movement towards the merger of several public sector programs and institutions.

These policy concerns and related initiatives are commendable. Nonetheless, they reveal one serious policy limitation, namely that problem diagnoses and solutions are almost always entirely within the context of the credit programs themselves. This paper advances the thesis that developments in the wider economy have a major influence on the viability of rural credit institutions and programs. Correspondingly, appropriate policy approaches should be less narrow in scope, encompassing the real sector and not confined to the financial sector or parts thereof.

The remainder of the paper elaborates on the importance of the wider policy approach, outlines the main channels of economy-wide influences, and by reference to Jamaica comments on their likely significance in the

Commonwealth Caribbean. Because public sector institutions and programs are not the only or even the largest creditors in the rural financial markets, the ensuing discussion is formulated in terms of rural financial markets to allow treatment of matters more germane to private financial institutions.

Why Consider Economy-Wide Influences

Financial markets are expected to contribute to rural development by improving the quantity and quality of rural savings, and by the provision of credit in amounts and forms that enhance productive capacity and rural equity. Evidence for a few countries leads to the conclusion that rural financial markets are not fulfilling these expectations in the CARICOM countries (see for Example Bourne 1976, Graham, Bourne and Begashaw 1978, Bourne and Graham 1980, Graham and Bourne 1980, and Weir et al 1980). Financial savings have not grown significantly in constant prices. Poor loan repayment performance and problems of funding have also prevented the sustained growth of rural credit. In several countries, such as Montserrat, St. Kitts-Nevis, St. Vincent, Dominica, and Jamaica, rural financial markets are in a state of acute depression.

Among the various approaches that might be taken to diagnose problems in the viability and performance of rural financial markets are indepth analyses of specific programs and institutions. Such studies invariably highlight the weakness of program design and managerial skills, poor coordination with other policies, ill-defined or inconsistent objectives, and too rapid changes in the size and composition of credit programs in the context of limited managerial skills and resources. Policy measures which emerge from intra project evaluations emphasize the need

for innovations in deposit facilities and savings mobilisation (Adams 1978, Bourne and Graham 1980), better credit delivery systems (Adams and Ladman 1979), improved credit appraisal and more effective loan monitoring and recovery procedures (Bourne 1976, Graham, Bourne, Begashaw 1978, Graham and Bourne 1980). The need to institute more flexible interest rate policies, in order to reduce the wide gap between low lending rates and high lending costs is frequently advised (Adams 1979, Datey 1978, Graham and Bourne 1980, Bourne 1980). Together, these intra-project reforms are expected to guarantee a viable, self-sustaining set of financial programs.

For the most part these policy recommendations are based on sound diagnoses. However, there usually is not sufficient recognition of the influence of the overall economic environment on rural financial market performance and on the efficacy of financial market reforms. A rural financial market is not an isolated set of institutions, transactors, and financial activities. It is a component of the total financial sector which is itself one of several sectors in the economy. Though functional and institutional fragmentation of the financial sector is characteristic of Caribbean economies, there are strong linkages between constituent elements of the financial sector and the rest of the economy. These links ensure that developments in rural financial markets both condition and are conditioned by developments in the wider economy. More usually, the influence of the latter is stronger and decisive.

An appreciation of interconnections is necessary for effective policy formulation at both the national economic and the financial institution levels. National and sectoral planners need to keep in mind

the economic interrelatedness if the risks of policy inconsistencies and unintended consequences are to be minimised. Top decision-makers in financial institutions need to convey the sectoral and market incidence of macroeconomic policy to macro-planners who think primarily in global terms.

How Economy-Wide Factors Affect Rural Financial Markets

The continued viability of rural financial institutions is an essential requirement for the achievement of the socio-economic objectives usually set for rural financial markets. Institutional survival and growth is necessary for the maintenance and expansion of financial programs. Accordingly, viability and growth are crucial indicators of rural financial market performance. Therefore, the influence of economy-wide factors can be examined in terms of their consequences for institutional viability and growth.

The crucial financial market variables are lending resources and the realized operating margin of rural lenders. These variables crystallize the outcome of more basic forces operating on both sides of the financial markets. Lending resources are increased by equity, debt and deposit liabilities, and decreased by the diversion of these capital inflows to operating expenditures. Realized operating margins are affected by interest and non-interest operating costs, by loan defaults, and by interest and other operating income. Savings and debt transactions constitute the link between these variables and rural non-financial enterprises. Savings and debt repayments contribute to loanable resources, while dis-savings and debt default have the opposite effect. Likewise, loan delinquency and

default increases lending costs and reduces net revenue. The channels of influence of economy-wide variables on these financial market operations will be discussed now. Five broad sets of economy-wide factors are considered: the general price level, product price policies, trade and foreign exchange policies, interest rate policies, and non-price credit restraint policies. Each is discussed in turn though they might operate simultaneously.

The General Price Level

The general price level can exert an influence on rural financial markets through the cost and revenue (or profit) functions of market transactors. If factor prices are indexed to the general price level, then changes in domestic price inflation will cause changes in wages and other factor costs of financial institutions and non-financial enterprises. However, these changes will most likely be asymmetric: domestic price inflation spilling over into cost increases for financial market transactors, but domestic price deflation unaccompanied by cost reductions. Unless the financial market transactors increase their product prices (i.e. loan charges and commodity prices) and/or improve total factor productivity, operating margins will be reduced by domestic price inflation. A profits squeeze may exert further depressing effects on financial institutions by reducing the capacity and willingness of non-financial enterprises and individuals to save and to repay debt. Resources inflows may thus be adversely affected and loan delinquency problems arise.

The strength and direction of the link between the domestic price level and factor costs are critical. Labour in the formal financial markets of the Commonwealth Caribbean is highly unionized. Aggressive unionism ensures that labour costs adjust fairly rapidly to general price increases. Further, despite the overall weaker degree of unionization in rural commodity sub-sectors, some segments of the labour market, e.g. plantation agriculture, are no less highly unionised than urban centered industries. Wages-spread and spillover mechanisms link wage rates in the two 'strongly unionized' and the non-unionized segments so that the unionized wage rate pulls up the non-unionized wage rate. The other factor markets tend to be oligopolistic or monopolistic, with suppliers of capital and intermediate inputs seeming to adjust their own product prices rapidly to price level increases in accordance with a full-cost pricing rule.

The role of real income in financial savings decisions is also important. The Caribbean consensus is that real income is the single most significant influence on domestic savings. Price level effects via changes in real income can therefore be expected to strongly influence the flow of loanable funds in rural financial institutions.

Product Prices

For generalised inflation to exert a profits squeeze on rural financial markets, the prices of credit and commodities must rise less rapidly than factor costs. There are several reasons for expecting such an outcome.

The loan charges of public sector credit institutions are subject to governmental directives and are often specified in contracts with external funding agencies. Loan rates of interest and fees are usually not only low

but rigid. Even under mild inflations, the rate of general price increases (and therefore cost increases) tend to exceed interest rate increases in public sector financial institutions. Private financial institutions mainly commercial banks, are not so severely affected through this channel since in most Commonwealth Caribbean countries they are free to increase loan rates of interest. However, the interest elasticity of loan demand places a market limit on the degree of upward interest rate revisions. As a consequence, private financial institutions also experience a cost squeeze under rapid inflation.

The main limitation on commodity price increases grows out of official price control policies. In pursuit of cheap food objectives, price controls are imposed on domestic farm products and on competing imported foodstuffs. Where the price of the domestic product is uncontrolled, but the price of the imported competitive commodity is set substantially below the price of the local farm commodity, a profits squeeze may still result. The 'cheaper' import either displaces the local product and has a quantity effect on gross revenues, or forces lower prices and has a price effect on the gross revenues of the domestic producer. Even where price controls are revised upwards to take account of increases in production costs, adjustment is usually not full and moreover is protracted. In such circumstances, some profits depression still occurs.

Interest Rates

Financial markets in the Commonwealtb Caribbean are subject to interest rate regulation as already noted in the case of loan rates of interest. There is no need to repeat the discussion on loan rates. Instead,

attention is directed to interest rate policies as they affect other assets and liabilities.

A financial institution is a multiproduct firm, providing a mix of financial credits at several prices. Its overall rate of return depends on the output of each credit-product and the price thereon. Commercial banks lend to non-rural enterprises and to government (either by direct loan or purchase of government debt instruments). Accordingly their overall income is affected by the rates of interest prevailing on these non-rural credits. Similarly, public sector credit agencies mainly for liquidity and capital purposes maintain a portfolio of market investment assets, essentially commercial bank deposits and government debt instruments.

Official policies have tended to keep the interest costs of government debt at a low level. Legal reserve requirements generate a compulsory demand for government debt among commercial banks. Moral suasion serves the same purpose among public sector credit institutions.

Partly because interest rates on savings instruments have been depressed for so long at such low levels, there is virtually no conclusive evidence on the likely effect of interest rate increases on savings in the Commonwealth Caribbean. The most that can be said is that thus far savings have not diminished significantly in response to the prevailing negative rates of interest. But this fact does not imply the converse, namely that substantial interest rate increases would not induce a substantially larger volume of savings. If savings are interest-sensitive, then the overall trend in savings rates of interest will influence the volume of funds mobilised locally by the commercial banks and other institutions that accept deposits. It remains to be said, also, that higher interest rates on deposits

imply higher lending costs for rural financial institutions. The savings rate of interest thus exerts its influence through the cost functions of rural financial institutions as well as through their lending capacity.

These sources of influence are not particularly germane for public sector credit agencies which obtain their loanable resources primarily from external donor agencies, local governments, and quasi-governmental institutions, though they are affected to the extent that they borrow from private financial institutions which accept local deposits. Private financial institutions are the ones most affected by the national behaviour of rates of interest on savings instruments.

Credit Restrictions

Quantitative credit restrictions are frequently imposed in pursuit of sectoral and global economic planning objectives. They tend to have an uneven impact on financial institutions within the financial sector as a whole as well as within the rural financial sub-sector. Public sector institutions are usually not subject to credit restraints. In contrast, private financial institutions may have to observe ceilings on their lending in total and to specific borrowing categories or economic sectors. More usually the restricted categories are among the more lucrative assets. One effect of these restraints therefore is to reduce the earning potential of the overall financial asset portfolio. Because of the rigidities in cost structures arising from the contractual nature of time deposits, these institutions will experience short run reductions in earnings relative to costs unless loan rates of interest are sufficiently increased.

On the borrowers' side of the market, global credit restraint may impart a liquidity squeeze, depending on the degree to which borrowing enterprises are reliant on banks for their working capital. The liquidity squeeze would be even greater if the credit contraction coincides with downward pressures on current profits and savings. These liquidity problems may easily spill over to lending institutions in the form of loan delinquency and, in extreme cases, in loan default.

Trade and Foreign Exchange

Foreign trade and foreign exchange developments influence rural financial market performance through their effects on the cost, production and revenue functions of financial and non-financial enterprises, and their effects on debt costs.

Import prices are an important component of factor costs in highly open economies. Import prices generate increases in the prices of raw materials and capital goods, and also in wage rates via changes in the cost of living. Changes in import prices (in domestic currency) are determined partly by changes in the exchange rate, and partly by changes in foreign export prices. For some Caribbean countries, e.g. Jamaica, exchange rate changes have been dominant in recent years. To the extent that rural product prices and financial product prices do not keep pace with factor cost increases induced by import prices, the net revenue functions of rural lenders and borrowers are adversely affected.

Quantitative import restrictions can also affect profitability and gross revenues at the enterprise level. Depending on the import-coefficient of production and on the scope for substituting local inputs,

restraints on imports of producer goods reduce production levels and efficiency with obvious consequences for gross and net revenues.

The debt cost consequences of exchange rate changes stem from the fact that some proportion of rural financial market liabilities are denominated in foreign currencies. Therefore, the local currency capital value equivalent of these debts varies directly with the direction and magnitude of change in the exchange rate. Devaluation increases the capital value of the debt in local currency while revaluation does the opposite. Increases in the capital values of the credit agencies' liabilities will lead either to increases in loan charges if profit margins are to be protected, or to some institutional decapitalization if profit margins are allowed to fall. A negative influence on institutional performance is also possible through the repercussions of devaluation on non-financial debtor behaviour. If debtors respond to the discontinuous increase in debt costs by loan delinquency and/or default, lending costs will rise to the detriment of the lending agency.

Economy-Wide Factors in Rural Financial Market Depression: A Jamaican Case Study

The Jamaican economy can be used to illustrate some of the mechanisms identified in the preceding section. The economy collapsed from a situation of positive growth of real gross domestic product averaging 5 percent per annum between 1965 and 1972 to an uninterrupted succession of negative annual growth rates ranging from 1 to 8 percent between 1974 and 1978.

Prolonged balance of payments problems, manifested by a movement from net foreign reserves of J$132 million in 1971 to minus J$196 million in 1977,

resulted in increasingly severe corrective policies of quantitative restrictions on imports, exchange rate devaluations totalling 54 per cent between 1970 and 1978, and domestic credit restraint. The economy is heavily reliant on imports for its supply of consumer and producer goods, with imports averaging 41 per cent of gross national expenditure over the period. Consequently, domestic prices are highly responsive to changes in import prices. The rate of inflation has risen sharply, averaging 15 percent during the 1970s, and was as high as 27 percent in 1978. Labor is highly unionized in all productive sectors, excluding domestic agriculture. Wage rates have generally kept pace with domestic price inflation.

The poor performance of the real sector was accompanied by serious problems within the financial sector, including the rural financial market. The rural financial market will now be briefly described, and its depression indexed.

The institutional complex that comprises the Jamaican rural financial market includes eight commercial banks operating a country-wide network of branches, and two specialized government-owned credit agencies, namely the Jamaica Development Bank and the Agricultural Credit Board. Commercial banks are the largest single source of credit as well as the main savings institutions. The Agricultural Credit Board is a non-deposit taking institution established solely for the purpose of making direct loans to large farmers and institutional loans to the national network of People's Cooperative Banks, which in turn make small loans to small farmers. The People's Cooperative Banks also mobilize rural savings but on a very small scale. The Jamaica Development Bank, established in 1969, is funded mainly through capital subscriptions and loans from the Jamaica Government

and from loans from foreign aid agencies. The Jamaica Development Bank operates a commercial loan window for medium to large farmers and, through an affiliated agency i.e. the Self-Supporting Farmers Development Program, maintains a loan facility for small to medium sized farmers. The Ministry of Agriculture provides rural credit services under several ad hoc programs, the most recent and important being the Crop Lien Program launched in 1977 to provide production loans to domestic foodcrop producers. Other financial institutions, such as building societies and life insurance companies, and informal groups such as rotating credit associations and credit unions complete the institutional structure of the rural financial market in Jamaica. While the rural savings and credit activities of the latter set of transactors cannot be precisely quantified, it does appear that most rural savings and credit are channelled through the commercial banks and specialized government programs. The ensuing discussion of rural financial market depression is focused on the commercial banks, the Jamaica Development Bank and the Self-Supporting Farmers Development Program.

In keeping with the emphasis on institutional viability and growth, four pertinent indicators of financial market performance are the behaviour of savings, credit, loan repayments, and profitability. Time series estimates of rural savings in Jamaica are not available. However, the behaviour of commercial bank total savings and time deposits provides some insight into the trends in rural savings mobilization. Real savings and time deposits after rising from J$223 million in 1970 to J$298 million in 1972, declined by 18 percent over the next two years, recovered slightly in 1975 and 1976, only to decline by roughly 7 percent in 1977. Overall, real savings at commercial banks stagnated from 1973 to 1978. Therefore,

it can be inferred that the savings side of the Jamaican rural financial market did not perform well during this period.

Rural credit, having expanded rapidly early in the 1970s, tended to decline after 1974. Real credit balances totalled $29 million in 1970, $35 m. in 1974, and $43 m. in 1978. The annual growth rate of credit (measured in constant 1970 prices) fell, negative growth being experienced in 1974 and dramatically so in 1978. The ratio of rural credit to agricultural gross domestic product at factor cost exhibits the same pattern as the dollar values of rural credit, i.e. a rise and then a decline.

Loan repayment data is not available for a sufficient number of years to permit similar trend analyses for loan repayment performance. However, the available information reveals a very unsatisfactory situation in 1977 and 1978 (Graham, Bourne, Begashaw). The ratio of arrears to payments due to Jamaica Development Bank commercial window loans reached system collapse levels of 81 and 83 percent in 1977 and 1978 respectively. The arrears ratio for the Self Supporting Farmers Development Program was as high as 38 percent in 1978. The commercial banks, largely because of their more stringent loan appraisal and recovery practices and their early write-off policy for bad debt, managed to keep their arrears ratio down to 4 percent in 1978. However, commercial banks did experience serious repayment problems. Their allowances for losses and bad debts as a proportion of total current operating expenses rose from an average of 4 percent between 1970 to 1975 to 6 percent between 1976 and 1977, and even higher to 11 percent in 1978. While these statistics on commercial bank performance do not pertain to agricultural loans exclusively, one may

infer from these data that commercial banks, like the public sector credit agencies, were experiencing difficulties in recovering rural loans.

There is no question that the profits performance of rural credit institutions deteriorated during the period analysed. The Jamaica Development Bank's ratio of operating income to total expenses tended towards 1.0 between 1971 and 1975, but decreased drastically to 0.3 by 1977. The commercial banks' ratio declined from 1.18 in 1970 to 0.98 in 1978.

The evidence on these financial indicators leads inescapably to the conclusion that Jamaican rural financial markets were very depressed in the 1970s, particularly in the latter half of the decade. Graham, Bourne and Begashaw have demonstrated that weaknesses in the design, implementation, and monitoring of rural credit programs explain much of this poor performance. However, these factors operating on the supply side, i.e. financial institutional side, do not fully account for the dismal experience. Events within the overall economy seriously contributed to the difficulties experienced within the rural financial sector. The importance of these more general influences will now be demonstrated.

The price behaviour of the economy contributed to the debt repayment problems experienced by Jamaican farmers. Domestic price inflation was rapid, averaging between 15 and 17 percent per annum during the decade. On the basis of the wage-price relationship prevailing in this economy, one could infer that agricultural wage rates along with other wage rates rose rapidly in response to the inflation of consumer prices. Annual wage settlements for all sectors of the economy during the period 1971 to 1976 ranged between 18 and 45 percent. Economy-wide labor incomes per worker

increased annually by an average of 10 percent. Agricultural incomes kept pace with the economy-wide trends. While no details are available on agricultural wage rates specifically, per worker compensation of employees in the agricultural sector rose by an average of 18 percent over the period, exceeding the national rate of increase of income per worker in 1975 and 1978.

The price of capital services also increased significantly over the period. The import price index rose by an average of 23 percent per annum. The annual increases were particularly large in 1973, 1974, 1977 and 1978. Substantial exchange rate devaluations occurred in the first and last two of these four years, while in 1974 OPEC raised petroleum prices substantially. Further, more direct support for the contention that the price of capital services increased greatly is provided by the data on unit prices of imported chemical fertilizers. The annual increases averaged 28 percent, and in 1974 more than doubled, again largely as a result of OPEC's impact on the price of petroleum and petroleum-based products. It can be concluded, therefore, that the price of capital services depressed gross agricultural profits.

These factor price trends do not appear to have been offset by increases in farm productivity. In the export sector, the index of tons of cane harvested per acre declined almost continuously from 100 in 1970 to 85 in 1977. Productivity per acre in domestic agriculture remained roughly the same from 1971 to 1976, but seems to have risen significantly in 1977 and 1978.

Quantitative restrictions also reduced farm profits. Import licensing became increasingly widespread and severe, with consequent

reductions in the availability of producer goods. For example, the quantity index of fertilizer imports declined by 11 percent in 1974, and then again by 6 percent in 1976 and 22 percent in 1977. The smaller supplies of improved inputs must have adversely affected production and productivity, and thereby farm revenues. The index of domestic food crop production declined slightly from 149 in 1972 and did not regain that level again until 1977 and 1978 when the massive governmental credit and physical support under the Emergency Production Plan succeeded in raising the index to 180 and 228 respectively. During this period, output decreased for the major agricultural export commodities, i.e. sugar and bananas by between 33 and 42 percent, and for quantitatively minor export commodities such as coffee.

Given these adverse trends in factor prices, output, and productivity, it is necessary to review the behaviour of agricultural commodity prices. It can be deduced that export prices rose on average more slowly than factor prices, adjusted for productivity declines. For instance, average annual percentage increases in the export prices of sugar and bananas, the two main export crops, were 20 and 18 percent respectively compared to an average annual price increase of 28 percent for fertilizers. Domestic agriculture seems to have fared no better, since there was only an average annual percentage increase of 20 percent for domestic farm-gate prices. It should be noted that farm-gate prices actually declined in 1978.

The preceding analysis leads to the conclusion that the increases in product prices did not totally offset increases in factor prices, nor production and productivity declines. Consequently gross profits were seriously squeezed. Direct evidence on profits reinforces this conclusion.

The National Income and Product Accounts provide data on a reasonable proxy for profits, namely real operating surplus defined as value added minus net labor, tax, and capital consumption expenditures. The real operating surplus of the agricultural sector declined by 5 percent in 1974, 4 percent in 1975 and 8 percent in 1978. Altogether agricultural gross profits fell by an average of 3 percent per annum between 1970 and 1978.

The lower levels of gross income flows occurred at times when price trends in the economy increased the money value of farm household purchases. Unless farmers were willing to accept substantially lower real levels of consumption, the rapid rate of consumer price inflation would result in larger money allocations to farm household consumption. No data is presently available on farm consumption expenditures specifically. However, the National Accounts data reveal that aggregate real private consumption expenditures did not fall until 1977 and 1978 when decreases of 4 and 10 percent were recorded. Most likely, farm families shared that experience.

Though it is not possible to be categorical about factor cost developments among the lending agencies, the evidence does suggest that these costs rose in response to the general inflationary trends in the economy. Labour costs in the commercial banking industry quintupled between 1970 and 1978, as did non-interest expenses of the Jamaica Development Bank.

The earnings performance of the commercial banks was significantly affected by official financial policies. Legal reserve requirements were frequently revised upwards, moving from 15 percent in 1969 to 29.5 percent

in 1977. Government direct borrowing from the commercial banks also increased. As a consequence, total commercial bank lending to government increased from 11 percent of bank assets in 1970 to 33 percent in 1977. At the same time, quantitative restrictions were placed on commercial bank lending to the private sector, particularly for consumption and import trade. Since the interest rate on government debt instruments and on direct debt were substantially lower than that on private debt, the income earning potential of commercial banks was continuously being undermined by these credit market policies. The negative tendencies were reinforced by the reduced demand for bank loans caused by the foreign exchange restrictions on import demand. Extensive foreign exchange rationing severely contracted the demand for bank credit among distributors and consumers.

It has been argued so far that changes in product and factor prices, output, and productivity contributed to rural financial market depression by substantially reducing the capacity of farmers to save, make profitable investments, and to repay debt. The influence of credit policies and trade policies on credit agencies was also dealt with. It will now be shown that debt service and amortization requirements also increased.

Commercial banks increased their loan rates of interest in an attempt to moderate the decline in net earnings caused by lower volumes of lending. On average, their nominal loan rates during 1974 to 1978 were three index points higher than rates in the 1970 to 1974 period (Bank of Jamaica Annual Reports). Loan charges of public sector credit agencies remained the same (Graham, Bourne, Begashaw). However, given the

large share of commercial banks in rural credit, overall rural loan rates of interest were pulled upwards.

Furthermore, frequent exchange rate devaluations, totalling 54 percent between 1970 and 1978, increased the local currency value of debt financed from foreign funds. Farmers are required to maintain the foreign currency values of such loans made by the Jamaica Development Bank. Consequently, exchange rate devaluation abruptly increases the local currency costs of these debts. Foreign funds comprised between 33 and 67 percent of loans extended by the Jamaica Development Bank during the period 1970 to 1978. Farm credit extended by other institutions are not based on foreign funds and consequently have been unaffected by the recent devaluations. Nonetheless, given the share of the Jamaica Development Bank program in the total supply of rural credit, a substantial proportion of farm debt must have been adversely affected.

Conclusion

This paper has dealt with the influence of economy-wide factors on rural financial market performance. The main channels of influence running from the general price level, product prices, credit market variables, and the foreign sector to the lending position and viability of rural credit institutions were outlined. The explanation of Jamaican rural financial market depression in these terms emphasizes the importance of the overall economic framework and policy measures taken outside rural financial markets.

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